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Financial Markets

Irving Trust

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Economic Research &
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(Noon)

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Prime rates rose again this week amid rampant uncertainty about what the Fed is doing. The FOMC met on March 27; we have since learned that, just prior to that meeting, a telephone conference resulted in a temporary lifting of the 10% ceiling on Fed funds. At the FOMC meeting itself, the range for Fed funds was probably moved up by one percentage point to 7%-11%. But the question remains: Where would the Fed like Fed funds to trade?

The market has become very jittery because Fed funds have been trading well over 10%--frequently over 10½%--in this new reserve maintenance period. The effective funds rate of 10.41% for the just-completed week is high by recent standards. The market has been continually disappointed by the Fed's failure to execute large System RPs to bring Fed funds down. Thus a consensus is building that Fed funds on average are going to trade above 10½%. While it's hard to split hairs over where Fed funds are supposed to be, let's look at how the Fed is operating. Can we read anything into the Fed's failure to do large RPs this past week?

In my last letter, I argued that we must look more at what rates the Fed allows the market to experience than at how the Fed achieves that result. But at the same time, we must realize that the Fed's operations do have some meaning--especially after the Fed has made a mistake. Last week was a sloppy reserve period for the Fed: It added; it drained; Fed funds firmed, then fell--sharply. The Fed clearly (to me anyway) executed its System RPs to "protect" the 10½% level of Fed funds on Thursday, March 22. But this proved to be a mistake, as Fed funds later fell sharply, prompting the Fed to mop up reserves with two rounds of matched sales. Thus the Fed learned a lesson: It's hard to judge reserve needs from Fed funds movements under CRA. The market can have such a strong demand for excess reserves (or simply lousy reserve forecasts) that even a very liquid market can push rates up. But as the end of the CRA period draws near, reserve forecasts can sharpen up. Banks may try to unload their hoard of excess reserves. Thus the funds rate can trade off--sharply.

Also bear in mind that this is the first time the Fed has allowed rates to move up substantially under CRA. It is reasonable to assume that the Fed too is learning. Last week's lesson was: Be careful about being too aggressive in defending rate levels. That leads to this week's operations, which find the Fed under-adding with a bill pass for the period, then doing small customer RPs to take the steam off the ensuing rise in rates. This adding is not aggressive, and it does not reassure the market. Yet the Fed does not want to be adding and then draining reserves in the same week.

The Fed's March 22 RP sent the message that the Fed is concerned that rates might get too high. This week's operations say: The honeymoon is over; we really can't spoon-feed the market its steady diet of stable Fed funds rates. So judgment is returning to Fed watching. I don't think that this means that the Fed has again become more reserves oriented. I just think that the Fed is conceding that the Fed funds rate has less information content as to reserve supply/demand conditions than it thought before. This implies that the funds rate may tend to trade with less stability in the future.

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Market Yields

	4/6/84 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	12.00%	11.50%	10.50%
Effective since	4/5/84		
Discount Rate at Federal Reserve Bank	8.50	8.50	8.50
Federal Funds	10.38	10.38	8.75
Repurchase Agreements	10.38	10.13	8.75
U.S. Treasury Issues			
Bills			
3 months	10.07	10.05	8.61
6 months	10.49	10.47	8.90
1 year	10.78	10.77	9.06
Coupons			
2 years	11.55	11.55	9.68
4 years	12.11	12.08	10.03
7 years	12.45	12.45	10.40
10 years	12.53	12.49	10.50
Long Bond	12.57	12.51	10.55
Negotiable Certificates of Deposit-Secondary Market			
1 month	10.30	10.25	8.80
3 months	10.35	10.40	8.80
6 months	10.60	10.62	8.95
1 year	11.25	11.25	9.30
Banker's Acceptances			
1 month	10.42	10.33	8.85
3 months	10.61	10.54	8.85
6 months	10.86	10.89	8.90
Eurodollar Deposits			
1 month	10.81	10.50	9.44
2 months	10.88	10.62	9.50
3 months	10.93	10.81	9.56
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	10.41	10.16	8.63
1 month	10.48	10.22	8.81
3 months	10.40	10.40	8.81
Bank Holding Companies			
1 month	9.71	9.45	8.81
Dealer Placed:			
3 months	10.65	10.45	8.97
New AA Corporate Utility Bond	13.70	13.75	11.85
Tax Exempt			
6 month Project Notes	5.60	5.90	4.60
1 year AAA Bond	5.75	5.75	5.25
5 year AAA Bond	7.40	7.40	6.50
20 year AAA Bond	9.70	9.70	8.85

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

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